Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Insurance and Research

July 7, 2006

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton
Director
Division of Insurance and Research

SUBJECT: Setting the Designated Reserve Ratio

SUMMARY AND RECOMMENDATION

Federal Deposit Insurance Reform Act of 2005 (the Reform Act) eliminates the current fixed designated reserve ratio (DRR) of 1.25 percent[1] and directs the FDIC's Board of Directors (Board) to set and publish annually a DRR for the Deposit Insurance Fund (DIF) within a range of 1.15 percent to 1.50 percent of estimated insured deposits.[2] The Reform Act also requires that the Board prescribe final regulations designating the reserve ratio after notice and opportunity for comment not later than 270 days after enactment of the Act.[3] Thereafter, any change to the DRR must also be made by regulation after notice and opportunity for comment.

The FDIC must set the DRR in accordance with its analysis of statutorily prescribed factors: risk of losses to the DIF; economic conditions generally affecting insured institutions; preventing sharp swings in assessment rates, and other factors consistent with these three factors.[4] Staff's analysis of these factors is set forth in the Supplementary Information section of

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[1] Section 2104 of the Reform Act, Pub. L. No. 109-171, 120 Stat. 9.

[2] Section 2105 of the Reform Act (to be codified at 12 U.S.C. 1817(b)(3)(B), (D)).

[3] Section 2109(a) of the Reform Act.

[4] The Reform Act provides:

> (C) FACTORS- In designating a reserve ratio for any year, the Board of Directors shall--
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> > (i) take into account the risk of losses to the Deposit Insurance Fund in such year and future years, including historic experience and potential and estimated losses from insured depository institutions;
> >
> > (ii) take into account economic conditions generally affecting insured depository institutions so as to allow the designated reserve ratio to increase during more favorable economic conditions and to decrease during less favorable economic conditions, notwithstanding the increased risks of loss that may exist during such less favorable conditions, as determined to be appropriate by the Board of Directors;

Concur: _______________
Douglas H. Jones
Acting General Counsel

the attached notice of proposed rule making and is summarized below. In sum, staff's view is that the best way to balance all of the statutory factors and preserve the FDIC's new flexibility to manage the DIF is to maintain the DRR at 1.25 percent.

Role of the DRR

The manner in which the Board evaluates the statutory factors may depend on its view of the role of the DRR, which may change over time. Staff has identified two potential general roles for the DRR: a signal of the reserve ratio that the Board would like the fund to achieve; and a signal of the Board's expectation of the change in the reserve ratio under the assessment rate schedule adopted by the Board.

Signaling a goal for the reserve ratio

Using the DRR as a signal of the reserve ratio that the Board would like the DIF to achieve could convey useful information to insured institutions and others about future deposit insurance assessment rates. Suppose, for example, the Board sets the DRR at 1.25 percent, intending it to be a target for the reserve ratio. If the actual reserve ratio was 1.30 percent, the industry and the public could reasonably infer that the Board would be less likely to raise assessment rates in the near term than either to leave them unchanged or lower them.

A key consideration in using the DRR to signal a goal for the reserve ratio is the amount of time that the Board would allow to achieve the desired ratio. As noted earlier, by eliminating the current fixed DRR and certain assessment rules triggered by the fixed DRR, the Reform Act permits the Board to manage the reserve ratio within a range. There is no statutorily required timeframe for a reserve ratio to achieve a specific DRR.[5] Nonetheless, a DRR viewed as a reserve ratio target to achieve over time would convey to the public that the Board would generally want to avoid a sustained, significant deviation of the reserve ratio from the DRR.

The staff's best estimate is that the reserve ratio is likely to be less than 1.25 percent at year-end 2006 primarily due to strong insured deposit growth. If the Board considers the DRR to be a goal for the reserve ratio and adopts the proposal to set the DRR at 1.25 percent, it would need to determine how soon the reserve ratio should return to 1.25 percent. The use of one-time credits required by the Reform Act will limit assessment revenue initially.[6] Therefore, if the

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> (iii) seek to prevent sharp swings in the assessment rates for insured depository institutions; and
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> (iv) take into account such other factors as the Board of Directors may determine to be appropriate, consistent with the requirements of this subparagraph.

Section 2105(a) of the Reform Act (to be codified at 12 U.S.C. 1817(b)(3)(C)).

[5] However, the Board must adopt a restoration plan when the fund falls below 1.15 percent. Section 2108 of the Reform Act (to be codified at 12 U.S.C. 1817(b)(3)(E)).

[6] Section 7(e)(3) of the Federal Deposit Insurance Act, as amended by the Reform Act, requires that the Board provide by regulation an initial, one-time assessment credit to each "eligible" insured depository institution (or its successor) based on the assessment base of the institution as of December 31, 1996, as compared to the combined aggregate assessment base of all eligible institutions as of that date, taking into account such other factors the Board may determine to be appropriate. The aggregate amount of one-time credits is to equal the amount that the FDIC

Board chooses to raise the reserve ratio to the DRR quickly and insured deposit growth is expected to remain strong, then a substantial increase in assessment rates might be required. The magnitude of the necessary assessment rate increase would likely diminish the more time that the Board allows the reserve ratio to climb back to its target.

Anticipating changes in the reserve ratio

Another role for the DRR would be to signal the Board's expectation of the change in the reserve ratio under the assessment rate schedule adopted by the Board.

For example, the Board may use the DRR to anticipate how the reserve ratio may move in response to changing economic conditions given the premium rate schedule adopted. Should deteriorating economic conditions precipitate an increase in bank failures that reduces the fund balance under the assessment rate schedule in effect, the Board could lower the DRR as the reserve ratio falls. Should improving economic conditions lead to a reduction in the fund's contingent loss reserve (estimated liability for anticipated failures), the Board could raise the DRR in recognition of the boost to the fund balance. In these two instances, using the DRR to signal expected changes in the reserve ratio is consistent with a statutory factor (discussed below) under which the Board would consider increasing the DRR during more favorable economic conditions and decreasing during less favorable ones.[7]

Assuming that insured deposit growth remains strong while institutions use their one-time assessment credits, the Board could adopt an assessment rate schedule under which the reserve ratio would likely decline temporarily. In recognition of the anticipated decline in the reserve ratio, the Board could lower the DRR for one or more years. As the depletion of the credits results in greater revenue and an increase in the reserve ratio, the Board could then raise the DRR.

Setting the DRR to anticipate the actual direction of change in the reserve ratio under a given assessment rate schedule would, however, convey little information about future changes in assessment rates. The Reform Act requires regulatory action for any further change in the DRR (subsequent to the initial determination under this rulemaking), with notice and opportunity for comment. Furthermore, in soliciting comment on any proposed change in the DRR, the FDIC must include in the published proposal a thorough analysis of the data and projections on which the proposal is based. While the FDIC can meet these requirements for changing the DRR in order to reflect expected near-term changes in the reserve ratio, the notice-and-comment process and accompanying analysis may be more useful in the context of changes to a DRR that serves as a longer term target for the reserve ratio.

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could have collected if it had imposed an assessment of 10.5 basis points on the combined assessment base of the Bank Insurance Fund and Savings Association Insurance Fund as of December 31, 2001. 12 U.S.C. 1817(e)(3).

[7] The reserve ratio may not necessarily rise (fall) under more (less) favorable economic and industry conditions. For example, the current economic outlook is generally good and industry conditions remain strong. Because of strong insured deposit growth and a low contingent loss reserve with little room for further reduction, there have been several consecutive quarterly declines in the reserve ratio.

Statutory factors

1. Risk of Losses to the DIF

Staff has estimated that potential loss provisions in 2006 related to future failures will range from $1 million to $241 million, with a best estimate of $93 million.[8] These estimates suggest that near-term losses to the insurance fund would not significantly alter the reserve ratio.

2. Economic Conditions Affecting FDIC-Insured Institutions

The performance of the economy and banking industry remains strong. The consensus expectation is that real economic growth will run near its long-run average of 3.0 to 3.5 percent in 2006, but will ease moderately in 2007 as higher interest rates continue to weigh on economic activity, especially the housing sector. In the banking industry, earnings have set five consecutive annual records, capital is at historically high levels, and asset quality remains solid. Banks in general appear to be well positioned to withstand the financial stress that may arise from potential economic shocks in the next few years.

3. Prevent Sharp Swings in Assessment Rates

The Reform Act directs the FDIC's Board to consider preventing sharp swings in the assessment rates for insured depository institutions. Given the use of initial assessment credits and the possibility of continued high insured deposit growth, maintaining a DRR of 1.25 percent is more likely to be consistent with relative premium stability if the Board also allows a period of a few years for the reserve ratio to meet the DRR. Raising the reserve ratio to a DRR of 1.25 percent quickly could require (depending on insured deposit growth) a substantial increase in assessment rates, which would exhaust credits rapidly, followed by a substantial reduction in rates once the DRR is achieved. Increasing the reserve ratio more gradually toward the DRR could result in less substantial increases (followed by less substantial reductions) in rates, consistent with this statutory factor.

4. Other Factors

Staff has identified certain "other factors" that the Board may choose to consider in setting the DRR. In staff's view, these factors favor maintaining the DRR at 1.25 percent.

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[8] The FDIC has estimated a likely range of insurance losses based on projected changes in the contingent loss reserve during 2006. These projections are influenced by several factors, including: (1) the shifting of problem banks among different risk categories within the reserve; (2) the reduction in problem banks due to improved financial conditions, mergers, or failures; and (3) the addition of new problem banks. To capture the effects of these changes, the FDIC uses a migration approach, which estimates the probabilities of banks entering into or leaving the group of banks included in the contingent loss reserve as well as the probability of banks moving between loss reserve risk categories. These probabilities are based on the recent history of changes to the reserve. Other factors driving changes in the contingent loss reserve are changes in expected failure rates and changes in rates of loss in the event of failure; however, for purposes of projecting changes to the contingent loss reserve, the FDIC assumes that failure and loss rates remain constant.

Transition to a new assessment system

Staff recommends against altering the DRR from the current 1.25 percent partly because the assessment system is about to undergo several significant changes. These changes include: (a) Staff's proposal that the FDIC adopt a new risk-based assessment system; (b) Application of the one-time assessment credits that will be available to those institutions that contributed in earlier years to the build-up of the insurance funds, which will limit assessment revenue in the near term; and (c) The change to a system where the reserve ratio will be managed within a range from a system where a hard target for the reserve ratio applied.

Midpoint of the normal operating range for the reserve ratio

The Reform Act in effect establish a normal operating range for the reserve ratio of 1.15 percent to 1.35 percent within which the Board has considerable discretion to manage the size of the insurance fund.[9] The current DRR of 1.25 percent is the midpoint of the normal operating range and staff believes that, at the commencement of the new assessment system, it would be reasonable to leave the DRR at the middle of this range.

Historical experience

Historical experience with a DRR of 1.25 percent indicates that it has worked well under varying economic conditions in ensuring an adequate insurance fund and maintaining a sound deposit insurance system.

Balancing the statutory factors

In staff's view, the best way to balance all of the statutory factors (including the "other factors" identified above that the Board may choose to consider) and to preserve the FDIC's new flexibility to manage the DIF is to maintain the DRR at 1.25 percent. Staff recognizes that the Reform Act directs the Board to consider allowing the DRR to increase in favorable economic conditions and that the present economic conditions are favorable. However, several other factors that the Board must (or may) consider – preventing sharp swings in assessment rates, the transitional nature of the assessment system, maintaining a DRR at the midpoint of the reserve ratio's normal operating range, the historical experience with a DRR of 1.25 percent, as well as the intent of the new legislation to provide the FDIC with flexibility to manage the reserve ratio within a range – all support or are consistent with maintaining the current DRR of 1.25 percent.

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[9] The Reform Act authorizes the Board to set the DRR at no less than 1.15 percent and no greater than 1.50 percent. The FDIC must adopt a restoration plan when the reserve ratio falls below 1.15 percent. When the reserve ratio exceeds 1.35 percent, the Reform Act generally requires the FDIC to begin to pay dividends. Because there is no requirement to achieve a specific reserve ratio within a given timeframe, these provisions in effect establish a normal operating range for the reserve ratio of 1.15 percent to 1.35 percent within which the Board has considerable discretion to manage the size of the insurance fund. Based on March 31, 2006 aggregate insured deposits of $4.002 trillion, a 20 basis point range for the reserve ratio would be equivalent to an $8 billion range for the fund balance.

Valuing securities held by the Deposit Insurance Fund

As discussed in the attached Memorandum to the Board of Directors dated May 31, 2006, staff has considered a change in the manner in which the DIF's securities are valued. This change would affect the calculation of the reserve ratio. For the reasons discussed in the Memorandum, staff proposes to defer a decision on whether to adopt this proposed change until some time after the new risk-based assessment system being considered by the Board has been adopted.

Staff Contacts

Division of Insurance and Research:

Munsell St. Clair
Senior Policy Analyst
(202) 898-8967

Division of Finance:

David R. Wylie
Team Leader
(703) 562-6178

Legal Division:

Christopher Bellotto
Counsel
(202) 898-3801

Attachments

May 31, 2006

MEMORANDUM TO: The Board of Directors

FROM: Steven O. App
Deputy to the Chairman and
Chief Financial Officer

Frederick S. Selby
Director, Division of Finance

SUBJECT: Designating and Valuing Securities Held in the
Deposit Insurance Fund's (DIF) Investment Portfolio

Executive Summary

The Investment Advisory Group (IAG), the group charged with overseeing the management of the DIF's investment portfolio, recently met to discuss the merits of designating all existing and future investment securities of the DIF as available-for-sale (AFS). The effect of this change would be to make the DIF's fund balance, and therefore its reserve ratio, potentially more volatile going forward. The IAG deferred a decision about whether to adopt this proposed change until such time as the new insurance assessment system, called for under the recently enacted deposit insurance reform legislation, is in place for a sufficient period of time.

Discussion

At present, the FDIC designates the DIF's investments in Treasury securities as either AFS or held-to-maturity (HTM) in order to ensure adequate levels of AFS securities are available to fund cash needs associated with potential bank and thrift failures. The portfolio's AFS security balance reflects the level of potential bank and thrift failure activity and the related estimated resolution funding needs. Participation in Financial Risk Committee meetings, discussions with Divisions of Resolutions and Receivership staff, discussions among the IAG members, and occasional special presentations to the IAG are all taken into consideration when establishing target AFS security balances. Furthermore, the IAG believes that a cushion to cover unexpected failures (that is, for failures related to institutions not currently on the problem bank list) is prudent given that it may take time to build up sufficient cash reserves and AFS security balances to fund such unanticipated resolutions.

Nevertheless, as the AFS security portion of the DIF investment portfolio grows from time to time, it interjects additional volatility into the fund balance. This volatility is based upon changes in Treasury yields, the shape of the Treasury yield curve, and the amount and average duration of the AFS security portion of the DIF's investment portfolio. To help balance the investment objectives of maximizing investment income while controlling fund balance volatility, AFS security maturity limits and other control techniques are used to help mitigate and control associated fund balance volatility. To calculate the DIF fund balance (the numerator of the reserve ratio), the FDIC values investment securities that are designated AFS at market value, which approximates fair value, and those that are designated HTM at amortized historical cost, consistent with generally accepted accounting principles. Specifically, in applying Statement of Financial Accounting Standard (SFAS) No.115, the FDIC has consistently demonstrated the positive intent and, more importantly, the ability to hold all HTM-designated securities to maturity, as represented to and opined on by the Government Accountability Office (GAO) for the last 12 consecutive years. Moreover, the fact that FDIC has never sold an HTM security corroborates our ability to hold such securities to maturity.

In a 2005 audit, the Office of Inspector General (OIG) recommended that the FDIC's Chief Financial Officer consider also including in its financial reports an alternate reserve ratio calculation that values the HTM portion of the investment portfolio at market rather than amortized historical cost.[10] The report noted that the recommendation would be most appropriate for a situation where the Board is permitted greater flexibility in the decisions related to the need to levy insurance assessments, than the situation prevalent at the time of the audit where the Board's discretion to make such decisions was quite limited and the Designated Reserve Ratio (DRR) of 1.25% represented a "hard target." While management opted not to immediately adopt the OIG's recommendation because of the limited discretion that the Board enjoyed at that time with respect to such matters, it noted in its response to the OIG's audit that if the then pending deposit insurance reform legislation provision was enacted that replaced the fixed DRR with a target reserve ratio that could vary within an acceptable range, then the OIG's recommendation would merit further consideration.

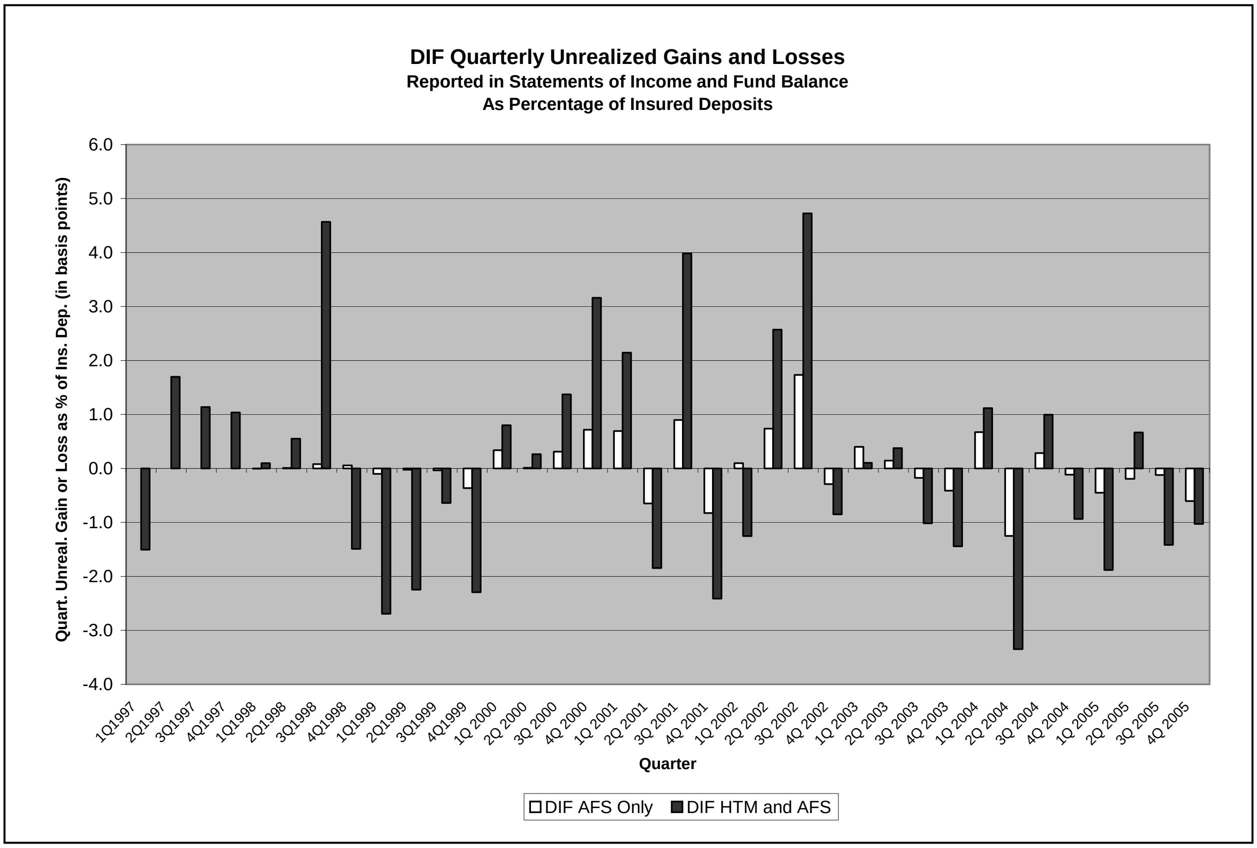
In light of the passage of deposit insurance reform legislation earlier this year, the IAG recently met and discussed the advantages and disadvantages of designating all existing and future DIF investment securities as AFS, the effect of which would be to continuously mark to market the entire DIF investment portfolio. While several arguments can be made in support of this proposed change, the IAG decided to defer this decision for several reasons, not the least of which was that it would make the DIF fund balance, and by implication, its reserve ratio much more volatile at the very same time the FDIC would be transitioning to a system of new deposit insurance rules that by themselves could result in greater variability in the reserve ratio.

As noted above, marking all DIF investments to market would make the reserve ratio more volatile by increasing the volatility of the fund balance as reported on the statement of financial position. Volatility would increase because the DIF's investment securities, which make up the lion's share of its current fund balance, would be much more sensitive to movements in interest rates. This would occur even though the unrealized gains (or losses) on the portfolio would not actually be realized, absent the need to liquidate investment securities to fund an actual bank or thrift failure.

The chart below compares, by quarter for the past nine years, the effect on the combined Bank Insurance Fund and Savings Association Insurance Fund reserve ratio (the hypothetical reserve ratio of the DIF had it existed during that period) of marking only AFS investments (our current

[10] OIG Audit No. 05-025, The FDIC's Investment Policies.

practice) with marking all investments (both AFS and HTM) to market (as proposed). As the data below indicate, marking all DIF's investments to market would have introduced significantly more volatility with respect to the portfolio's valuation, and, by implication, its related reserve ratio. For example, adoption of the proposed change would have caused approximately a four and one-half basis point swing in the combined reserve ratio for the third quarter of 1998.[11]



In addition to the volatility that the proposed change would likely add to the DIF's reserve ratio, it should be noted that adoption of this change would also severely limit the FDIC's freedom to designate newly purchased securities as either AFS or HTM at the time of purchase going forward. Specifically, by choosing to reclassify all existing HTM securities to AFS, FDIC would lose its discretion to classify all of its newly purchased investment securities as HTM for at least two years from the reclassification date.[12] Hence, the adoption of this change would have

[11] Calculated as the quarterly change in the DIF HTM and AFS less the quarterly change in the AFS only, divided by estimated insured deposits.

[12] Accounting literature, including Statement of Financial Accounting Standards No. 115, does not cite a specific two-year period before securities could be designated HTM. However, in practice, the Securities and Exchange Commission has permitted entities to reestablish HTM security classifications only after a two-year period from the reclassification date.

repercussions for the DIF fund balance and its related reserve ratio for a considerable period beyond the date the proposed change was adopted.

Conclusion

Marking all of the DIF's investment securities to market would make the reserve ratio much more volatile at a time of transition to a system of new deposit insurance rules. Hence, the IAG decided to defer a decision on this proposal at this time. The IAG will revisit this decision once the new insurance assessment system is in place for a sufficient period of time.

RESOLUTION

WHEREAS, section 7(b)(3) of the Federal Deposit Insurance Act (FDI Act), as amended by the Federal Deposit Insurance Reform Act of 2005 (Reform Act), directs the Board of Directors (Board) of the FDIC to set and publish annually a designated reserve ratio (DRR) for the Deposit Insurance Fund within a range of 1.15 percent to 1.50 percent of estimated insured deposits; and

WHEREAS, section 2109(a)(1) of the Reform Act requires the FDIC to prescribe by regulation, after notice and opportunity for comment, the designated reserve ratio not later than 270 days after the date of enactment of the Reform Act; and

NOW, THEREFORE, BE IT RESOLVED, that the Board hereby authorizes publication in the Federal Register of the attached notice of proposed rulemaking through which part 327 would be amended to designate the reserve ratio as required by the Reform Act and the FDI Act.

BE IT FURTHER RESOLVED, that the Board hereby delegates authority to the Executive Secretary, or his designee, and the General Counsel, or his designee, to make technical, nonsubstantive, or conforming changes to the attached notice and to take such other actions and issue such other documents incident and related to the foregoing as they deem necessary or appropriate to fulfill the Board's objective in connection with this matter.